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IN THE

Supreme Court of the United States

OCTOBER TERM, 1932.

No. 215.

E. G. PALMER,

Petitioner,

versus

MRS. AGNES McGRAWL BENDER, Administratrix of the Estate of Jacob O. Bender, Late Collector of Internal Revenue for the District of Louisiana,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF OF PETITIONER.

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR PETITIONER.

1.

Opinions Below.

The opinion of the United States District Court for the Western District of Louisiana (R. 98) is reported in 49 F. (2d) 316. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 424) is reported in 57 F. (2d) 32.

II.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered March 26, 1932 (R. 425). A petition for rehearing was submitted on April 12, 1932, and denied April 23, 1932. The petition for certiorari was filed July 12, 1932, and granted October 17, 1932 (R. 430). The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

III.

Summary Statement of the Case.

Petitioner brought this suit in the District Court for the Western District of Louisiana, to recover additional income taxes assessed against and paid by him, for the years 1921 and 1922, on account of his interest in two partnerships, the J. E. Smitherman, Special Account, and the George O. Baird partnership. That court denied recovery on the issues now before this Court and he appealed to the Circuit Court of Appeals for the Fifth Circuit, which affirmed the judgment of the lower court.[1] A rehearing was applied for and refused. Petition for a writ of certiorari was granted by this Court on October 17, 1932.

The case was tried to the court (R. 26), and submitted upon stipulations and agreed statements of evidence (R. 92,

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[1] One issue, not involved here, was decided in petitioner's favor (R. 115-116, 127), and respondent took a cross appeal (R. 375, 379). The judgment was affirmed (R. 424), 57 F. (2d) 32. Respondent did not ask for a rehearing, or petition this court for a writ of certiorari.

178, 320, 322, 324, 335). The trial court made special findings of fact and conclusions of law on the requests of both petitioner (R. 28, 59) and respondent (R. 61).

The partnership, J. E. Smitherman, Special Account, formed in 1919, acquired oil and gas leases on 26,000 acres of land near Haynesville, Louisiana, in the name of J. E. Smitherman, in whose name all subsequent contracts were made (R. 29-30).

During 1919, 1920 and 1921, several wells were drilled, but no oil was discovered until March 30, 1921, when a producing well was completed, in a discovery area, located on four of the leases (Exhibits "H" (R. 198); "I" (R. 204); "J" (R. 209), and "K" (R. 213) (R. 31)). On April 23, 1921, the partnership transferred to the Ohio Oil Company 120 acres of the 160 acres on which the well was located, by an instrument in writing (Exhibit N, R. 31-33, 242).

The consideration for that transaction was $3,000,000 cash, $1,000,000 out of one-half of the first oil produced and saved from the leased premises and the further obligation of the Ohio Oil Company to pay over and deliver to Smitherman "the equal one-eighth (⅛) of all oil produced and saved from the above described premises as an excess royalty." . . . The recited consideration of $3,000,000 was paid by the Ohio Oil Company, and the partnership subsequently received the additional $1,000,000 provided for in that agreement (R. 74).

In 1919, the George O. Baird partnership, through George O. Baird, acquired an oil and gas lease on a then unproven area in Claiborne Parish, Louisiana, on which it drilled a well which resulted in the discovery of oil on August 23, 1919. The Commissioner of Internal Revenue recognized the partnership as discoverer under the Revenue

Act then in force (R. 92-94) and the depletion unit established on the fair market value of the property at the date of discovery.

On November 16, 1921, Baird, acting for the partnership, made an agreement with the Gulf Refining Company of Louisiana, which was embodied in a written contract (Exhibit "Y," R. 313). The Gulf Refining Company under the terms of the agreement obligated itself to loan the Baird partnership $350,000,[2] to pay it $325,000 by delivering 60% of the oil produced from the property, and in addition to deliver to it for a term of three years "one twenty-fourth (1/24) of all of the oil that may be saved from that produced from the said property," and after three years "a royalty of one thirty-second of all the oil that may be saved from that produced . . . as long thereafter as oil may be produced from the said property in paying quantities" (R. 313-317).

In 1921 and 1922, petitioner reported as income his distributive share of the income of the Smitherman partnership, taking deductions for depletion based on the valuation of the property on the date of discovery, or within thirty days thereafter, against the bonus of $3,000,000 cash, and the $1,000,000 paid out of one-half of the oil. The Commissioner of Internal Revenue disallowed the deduction on the theory that the transaction with the Ohio Oil Com-

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[2] This $350,000 was paid by the Gulf Refining Company to one Munhall, assignee of J. Rogers Flannery (R. 96), as a condition precedent to repossession of the leased premises under a judgment (Exhibit "X," R. 290, 309) resolving a prior sale of the lease made by the partnership to Flannery (Exhibit "W," R. 300). The Commissioner of Internal Revenue included this amount in income of the partnership. In this suit, the trial court decided that it should be excluded (R. 115-116), and rendered judgment accordingly (R. 127). It is not now involved here, as previously explained (Note 1, p. 2, *ante*).

pany was a sale and not a sub-lease (R. 51-54) (Exhibit "C," R. 182). Petitioner also reported as income for 1921 and 1922, his distributive share of the income of the Baird partnership, claiming a deduction for depletion on account of discovery value against that part of $325,000 payment in oil from the contract with the Gulf Refining Company. This deduction was also disallowed by the Commissioner for the same reasons (Exhibit "F," R. 188; R. 52-54, 90).

This resulted in the determination of a deficiency in petitioner's tax (R. 195-198). The amount of the deficiency, interest added, was assessed against petitioner and paid by him under protest (R. 154-155). This suit was brought to recover the amount so paid.

IV.

Specifications of Error.

Errors assigned by petitioner to be relied on are:

(1)

That the United States Circuit Court of Appeals erred in disapproving Article 215 (a), Treasury Regulations 62, as amended by Treasury Decision 3938.

(2)

That the said court erred in not holding that Article 215 (a), Treasury Regulations 62, as amended by Treasury Decision 3938, constitutes a proper interpretation and application of the depletion provisions of the 1921 Revenue Act.

(3)

That the said court erred in not holding that petitioner, as a member of the Smitherman partnership and Baird partnership, was entitled to depletion deductions in 1921 and 1922 with respect to the bonuses or advanced royalties received by those partnerships.

(4)

That the said court erred in denying petitioner's claim for refund, which claimed refund was based on depletion deductions with respect to the bonuses or advanced royalties received by the partnerships.

(5)

That the said court erred in holding the contract between James E. Smitherman and the Ohio Oil Company, dated April 23, 1921 (Exhibit "N", R. 242), and the contract between George O. Baird and the Gulf Refining Company, dated November 26, 1921 (Exhibit "Y," R. 313), to be sales or assignments, and in not holding them to be sub-leases.

(6)

That the said court erred in not construing those contracts according to the Civil Law of Louisiana, as distinguished from the Common Law, and in not following the jurisprudence of Louisiana as reaffirmed in *Roberson* v. *Pioneer Gas Co.*, 173 La. 313, 137 S. Rep. 46.

(7)

That the said court erred in not giving effect to the doctrine of *Roberson* v. *Pioneer Gas Company, supra,* as to the distinction between sub-leases and assignments.

(8)

That the said court erred in holding the over-riding or excess royalty respectively reserved by Smitherman and Baird in the aforesaid contracts to be part of the purchase price of a sale.

(9)

That the said court erred in not holding such excess royalties to be rent, as established by the Revised Civil Code of Louisiana and the jurisprudence of the Supreme Court interpretative thereof; and particularly Revised Civil Code, Articles 2439, 2464, and 2671, and *Logan* v. *State Gravel Co.,* 158 La. 105; *Board of Commissioners* v. *Pure Oil Co.,* 167 La. 801; *Wilkins* v. *Nelson,* 161 La. 437.

(10)

That the said Court erred in holding the failure of the Ohio Oil Company and the Gulf Refining Company to respectively pay Smitherman and Baird the over-riding or excess royalties retained by them would not entail forfeiture of the rights of the Ohio and Gulf companies under the said contracts; which ruling of the court is in direct conflict with the Revised Civil Code of Louisiana and the interpretative jurisprudence of the Supreme Court of Louisiana, particularly, Revised Civil Code, Article 2712, and *Louisiana Oil Refining Corporation* v. *Cozart,* 163 La. 90.

(11)

That the said court erred in holding that even if the instruments in question constituted sub-leases, the petitioner, as a member of the Smitherman and Baird partnerships, discoverers of the oil wells in question, would not be entitled to depletion deductions based on discovery revaluation, said deductions to be taken against the bonuses or advanced royalties received.

(12)

That the Circuit Court of Appeals erred in not reversing the decree of the District Court and in not remanding the case with instructions to render judgment in favor of the petitioner as prayed for.

V.

Argument.

Summary.

Section 214 (a) (10), Revenue Act of 1921, provides in part as follows:

> (a) That in computing net income there shall be allowed as deductions:
>
> (10) In the case of mines, oil and gas wells, . . . a reasonable allowance for depletion . . . according to the peculiar conditions in each case . . . : Provided, further, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially dis-

> proportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; . . . In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

The trial court found as facts that the Smitherman partnership drilled the discovery well on the leases involved (R. 31); that the total area, up to the date of discovery, was developed solely by the partnership and not as a result of the purchase of a proven tract or lease (R. 51); that the fair market value of the discovery area at date of discovery or within 30 days thereafter was $6,371,500, of which $5,200,000 represented the fair market value of the property affected by the transaction with the Ohio Oil Company (R. 50); and that such fair market value was disproportionate to the cost (R. 51).

The right of the Baird partnership to depletion based on discovery value was recognized by the Commissioner of Internal Revenue (R. 92-94).

The Regulations of the Treasury Department in existence at the time of the Smitherman-Ohio transaction (Article 215 (a), Regulations 45, 1920 Edition) provided for depletion deductions by a lessor against a bonus or other sum received in addition to royalties.

Article 215 (a) of Regulations 62 applying the 1921 Revenue Act was identical.

In November, 1926, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, amended Article 215 of Regulations 45, and Article 215 of Regulations 62, by Treasury Decision 3938, V-2 C. B. 117, which, in part, is as follows:

> (a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to the proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of the royalties thereafter received.

Petitioner contends that a sub-lessor is likewise entitled to the benefits of the depletion deductions provided for by the Revenue Act under the rules and regulations prescribed by the Treasury Department (*Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364).[3] That is particularly true in Louisiana, where a sub-lease is in all respects a new lease ingrafted on the primitive lease (*Smith* v. *Sun Oil Co.*, 165 La. 907; *Roberson* v. *Pioneer Gas Co.*, 173 La. 313).

Petitioner contends that the Smitherman transaction with the Ohio Oil Company and the Baird transaction with the Gulf Refining Company effected sub-leases, and are within the intendment of the cited provisions of the Revenue Act and Treasury Regulation, because they provided

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[3] Respondent has never seriously denied this proposition. In the *Appeal of L. T. Waller*, 16 B. T. A. 574, involving the identical Smitherman-Ohio Oil Company transaction, the Government conceded that if the transfer was a sub-lease petitioner would be entitled to depletion. In this case, in the Circuit Court of Appeals, respondent's brief stated that "under the applicable statutes and Treasury Department Regulations . . . a lessor, including a sub-lessor, of mining property is entitled to a deduction from income on account of depletion" (Brief 24). For the first time in the history of this litigation, respondent has mildly suggested in the brief filed here in opposition to the petition for certiorari that the Revenue Act and Regulations do not apply to sub-lessors.

for the payment of royalties in addition to the payment of bonuses. That is particularly true in Louisiana, where royalty under an oil and gas lease is considered to be rent (*Logan* v. *State Gravel Co.*, 158 La. 105; *Board of Commissioners* v. *Pure Oil Co.*, 167 La. 801); and where the stipulation for a new rental in the transfer of a lease (as, for example, the provision for an excess royalty in the transfer of an oil and gas lease) characterizes the transfer as a sub-lease and not as a sale (*Smith* v. *Sun Oil Co.*, 165 La. 907; *Roberson* v. *Pioneer Gas Co.*, 173 La. 313).

The Circuit Court of Appeals considered the transactions to be assignments or sales, and not sub-leases; and stated that even if sub-leases, petitioner would not be entitled to depletion deductions in language which was tantamount to holding that the Treasury Regulation is not a reasonable interpretation of the Revenue Law providing for depletion deductions on discovery valuation.

Questions Presented.

There are, therefore, presented these questions:

1. Is Article 215 (a) of Treasury Regulations 62, as amended by Treasury Decision 3938, providing for allowances for depletion based on bonus received in addition to royalties, a reasonable and proper application of Section 214 (a) of the Revenue Act of 1921?

2. Is a sub-lessor entitled to deductions for depletion on the bonus he receives in addition to royalties under Section 214 (a) of the Revenue Act of 1921, and Article 215 (a) of Treasury Regulations 62, as amended?

3. Were the transfers of the oil and gas leases from Smitherman to the Ohio Oil Company and from Baird to the Gulf Refining Company sales (assignments) or subleases?

ARGUMENT.

I.

Article 215 (a) of Treasury Regulations 62, as amended by Treasury Decision 3938, providing for allowances for depletion based on bonuses or other sums received in addition to royalties, is a reasonable and proper application of Section 214 (a) of the Revenue Act of 1921.

The Circuit Court of Appeals in this case held, in effect, that Article 215 (a) of Treasury Regulations 62, as amended by Treasury Decision 3938, providing for allowances for depletion based on bonus received by a lessor in addition to royalties, is not a reasonable or proper application of Section 214 (a) of the Revenue Act of 1921. It denied petitioner's right to depletion based on the bonus or advanced royalties, saying, in part (R. 425; 57 F. (2d) 32, 35):

> It is not reasonable to suppose that either the Ohio Oil Co. or the Gulf Refining Co. should surrender the benefit of the depletion allowance on $4,000,000 in the one case and $325,000 on the other.

Later in the opinion it is stated:

> It is almost inconceivable that it was the intention of Congress to withhold an allowance for depletion from the operator of an oil and gas lease who produces all the oil and upon the production of which

> he owns the greatest portion, and grant it to the holder of an overriding . . . royalty.

These reasons for holding the Regulation invalid are unique, and are obviously inconsistent with Section 214 (a) (10) of the Revenue Act of 1921.

The Ohio Oil Company and the Gulf Refining Company acquired proven leases after March 1, 1913. Not being discoverers, the basis for the depletion to which they are respectively entitled is cost (see Article 203 (d), Regulations 62). On such basis the Ohio Oil Company was entitled to depletion on three-fourths of the oil produced from the date of the sub-lease. Neither the statute nor the regulation withholds the allowance from the operator of an oil property and grants it to the holder of an over-riding royalty, as the court below indicates. The Ohio Oil Company is entitled to depletion on all of its share of the oil, but its depletable base is measured by its cost. By its sublease, the Ohio Oil Company acquired a proven territory, which excludes it from the category of discoverers.

The Smitherman and Baird partnerships, being discoverers, are entitled to depletion based on fair market value on the date of discovery, or within 30 days thereafter (Section 214 (a) (10), Revenue Act of 1921). The petitioner here is asking for depletion only on the bonus payments, depletion on the one-eighth excess royalty having heretofore been allowed by the Commissioner.

It is obvious that the depletion allowances are wholly independent, and that the allowance of depletion based on discovery valuation to the Smitherman and Baird partnerships could not possibly deprive the Ohio and Gulf Companies, who acquired their rights after discovery, of their rights to depletion based on cost.

In *Murphy Oil Co.* v. *Burnet*, 15 B. T. A. 1195, the Board of Tax Appeals disapproved the Regulation in question on an entirely different ground. It held that the depletion deduction can only be measured by the oil produced, and that the allowance of depletion against bonuses or advanced royalties is a departure from the depletion concept.

The Circuit Court of Appeals for the Ninth Circuit reversed the Board of Tax Appeals and expressly approved the identical regulation (55 F. (2d) 17), saying, in part:

> The regulation is not only not in conflict with the statute, but directly conforms thereto,

and reversed the Board.

Certiorari was granted (286 U. S. 541), and the Murphy Oil Co. is asserting in this Court the invalidity of the Regulation on the grounds assigned by the Board of Tax Appeals for its decision.

In the *Murphy* case the "basic date" for valuation for depletion purposes was March 1, 1913, the property having been acquired by the lessor prior to that date. In this case the "basic dates" for valuation for the same purpose are the dates of the discovery of oil by the Smitherman and Baird partnerships, who were sub-lessors, in the contention of petitioner.

In a recent opinion, this Court referred with approval to the Statute, Treasury Regulations and court decisions which establish depletion allowances against bonuses received by the lessor of mineral properties in addition to royalties.[4] While the question was not there presented pre-

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[4] *Burnet, Commissioner* v. *Harmel*, Number 26, October term, 1932, Opinion November 7, 1932, reversing *Harmel* v. *Commissioner*, 56 F. (2d) 153 (C. C. A. 5).

cisely as it is in this case, the effect of that decision is such as to require only a brief discussion of petitioner's contention that the amended Regulation in question is valid, and that only with respect to the contrary argument made in the *Murphy Oil Company* case, *supra.*

The legislative history of the depletion provisions of the Revenue Acts clearly demonstrates that Congress did not intend that depletion deductions should coincide with actual extraction. It is admitted that depletion from gross income on account of the extraction of the oil which produces the income is not allowed as a matter of right. *Stanton* v. *Baltic Mining Co.,* 240 U. S. 103, 114; *Burnet* v. *Thompson Oil and Gas Co.,* 283 U. S. 301. Its sanction is statutory.

Congress failed to make provision for any such deduction in the Corporation Excise Tax Act of 1909 (c. 6, 36 Stat. 112, Sec. 38), but, recognizing the hardship resulting from this omission because of the peculiar character of mineral properties, it provided for depletion deductions in the later Revenue Acts (*U. S.* v. *Ludey,* 274 U. S. 295, 303). In the Income Tax Section of the Tariff Act of October 3, 1913 (c. 16, Sec. II, 38 Stat. 114, 166-167) an allowance was made, the validity of which was sustained by this Court (*Stanton* v. *Baltic Mining Co., supra*).

In the case of oil and gas wells, the Revenue Act of 1916 (c. 463, 39 Stat. 756) provided for a "a reasonable allowance for actual reduction in flow and production" (Section 12 (a) Second).

Section 214 (a) (10) of the Revenue Act of 1918 provided in the case of oil and gas wells that there should be deducted from gross income "a reasonable allowance for depletion . . . according to the peculiar conditions in each

case. . . . Such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary."

This plenary delegation of authority has had the approval of this Court. In *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, this Court said:

> It is clear that Congress intended that the lessee of an oil well should be entitled to a reasonable allowance for depletion based upon cost or March 1, 1913, value. It did not, however, attempt to prescribe a formula for ascertaining it, but expressly delegated that function to the Commissioner of Internal Revenue, who was to make rules and regulations to that end.

The broad discretion thus given to the Commissioner does not indicate an intention to allow deduction for depletion only coincident with actual extraction. In the exercise of this discretion the Commissioner soon thereafter issued Regulations 45, Article 215 of which provided that where a lessor received annual minimum royalties, which entitled the lessee to actual extraction of the number of units paid for, a depletion deduction should be allowed the lessor based on the value in the ground of the units paid for by the minimum rental. This was a clear recognition of the right to depletion before actual extraction, and was in accordance with the fundamental purpose of the Revenue Act—to tax true annual net income.

In the 1920 edition of Regulations 45, Article 215 was enlarged so as to provide that a bonus paid to a lessor in addition to royalties should be regarded as a return of capital, but only to the extent of the capital remaining to be recovered by the lessor through depletion. The same

provision was retained in subsequent regulations.[5] On November 13, 1926, Article 215 (a) of Regulations 45 and 62 and 216 (a) of Regulations 69 were amended by T. D. 3938 so as to provide that when a lessor received a bonus in addition to royalties, a depletion deduction should be allowed with respect to the bonus to the extent of that proportion of the basic value which the bonus bore to the sum of the bonus and royalties expected to be received. This provision was continued in Regulations 74 (Art. 236 (a)) under the Revenue Act of 1928. The principle of depletion against bonus was not changed; the method of computing the deduction alone was affected.

The provision for depletion as it appeared in the Revenue Act of 1918 was continued without substantial change in the Revenue Acts of 1921, 1924, 1926, 1928, and 1932. Congress has five times substantially reenacted the depletion provisions of the Revenue Act, in a period of 13 years, during which the Treasury Regulations have consistently provided for a depletion deduction in advance of extraction. This is persuasive evidence of legislative approval of the Regulation, and amounts to implied legislative confirmation of such executive interpretation. See *U. S.* v. *Falk,* 204 U. S. 143; *U. S.* v. *Cerecedo Hermanos y Compañia,* 209 U. S. 337; *National Lead Co.* v. *U. S.,* 252 U. S. 140, 146-147; *Heiner* v. *Colonial Trust Co.,* 275 U. S. 232, 235; *Brewster* v. *Gage,* 280 U. S. 327, 337; *Burnet* v. *Thompson Oil & Gas Co.,* 283 U. S. 301, 307-308; *U. S.* v.

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[5] Article 215 (a) and (b) of Regulations 62 under Revenue Act of 1921.

Article 216 (a) and (b) of Regulations 65 under Revenue Act of 1924.

Article 216 (a) and (b) of Regulations 69 under Revenue Act of 1926.

Kirby Lumber Co., 284 U. S. 1; *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552. This precludes any argument that the depletion deduction must be coincident with actual extraction.

The provision in the Regulations which treats bonus as advanced royalty and allows depletion against both bonus and royalty is fully justified because it is the only means by which the underlying purpose[6] of the Revenue Acts to tax true annual income can be fulfilled.

The depletion deduction is an allowance to compensate for partial exhaustion of mineral reserves. Gross income from the operation of mining property represents a return both for the use of capital, and for its exhaustion. Its nature has been so described by this Court (*U. S.* v. *Ludey*, 274 U. S. 295). So long as the mineral property is operated by the owner, or in cases where the lessor's only income is from royalty, the operation of depletion keeps step with actual exhaustion. The problem presented where the lessor receives both bonus and royalties is logically solved by the Regulation as amended by T. D. 3938.

When the lessor receives a bonus in addition to royalties, the bonus is an advanced or supplemental royalty,—a part of the royalty in a lump sum or down payment. It was so

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[6] This Court has repeatedly pointed out that that purpose is to tax true annual net income (*United States* v. *Anderson*, 269 U. S. 422; *Mitchell* v. *United States*, 271 U. S. 9; *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92; *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359). The purpose cannot be effectuated with respect to bonus payments unless they are treated as advanced royalties and an allowance made against them for depletion.

held by this Court in *Work* v. *Mosier*, 261 U. S. 352.[7] See also *Burnet* v. *Harmel*, No. 26, October term, 1932, U. S. Supreme Court; *Burkett* v. *Commissioner*, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Berg* v. *Commissioner*, 33 F. (2d) 641 (Ct. App. D. C.), certiorari denied, 280 U. S. 598; *Alexander* v. *King*, 46 F. (2d) 235, 239-240 (C. C. A. 10th), certiorari denied 283 U. S. 845; *Ferguson* v. *Commissioner*, 59 F. (2d) 891 (C. C. A. 10th); *Hirschi* v. *United States*, 67 Ct. Cls. 637, certiorari denied, 280 U. S. 576; *Appeal of Nelson Land & Oil Co.*, 3 B. T. A. 315, 326; *Cf. United States* v. *Biwabik Mining Co.*, 247 U. S. 116, 121.

That bonus is advanced royalty has been the basis for decisions requiring the lessee who has paid a bonus for a lease to distribute the deduction therefor as an expense over the entire life of the lease, because the bonus was an advance rental or royalty.[8]

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[7] In this case the Circuit Court of Appeals for the Fifth Circuit did not consider *Work* v. *Mosier* applicable because it involved the leasing of Indian lands. A similar error by that court with respect to the nature of bonus and royalty in oil and gas leases was recently corrected by this Court in *Burnet* v. *Harmel*, *supra*.

[8] It was so held:

By the Bureau of Internal Revenue:

Article 109, Treasury Regulations 45 and 62;
Article 110, Treasury Regulations 65 and 69;
Article 130, Treasury Regulations 74; I. T. 1711, II-2 C. B. 104; A. R. R. 6459, III-1 C. B. 138.

By the Board of Tax Appeals:

Nelson Land & Oil Co., 3 B. T. A. 315, 325-326; *Burkett* v. *Commissioner*, 7 B. T. A. 560, affirmed, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Hazlett* v. *Commissioner*, 10 B. T. A. 332, 337; *Parkey* v. *Commissioner*, 16 B. T. A. 441, 445; *Baton Coal Co.* v. *Commissioner*, 19 B. T. A. 169, affirmed, 51 F. (2d) 469 (C. C. A. 3d), certiorari denied, 284 U. S. 674; *Ferguson*

This view is sound because both bonus and royalties alike are consideration derived by the lessor from the use of property which is wasted in use. Depletion must be applied to income from the use of property which consumes it, and as to the lessor that income comes to him not merely as royalties but as bonus.

If depletion deduction is not applicable to bonuses received in addition to royalties, the taxpayer's income will be distorted so as to defeat the purpose of the Act to tax true annual income, because the entire amount of the depletion allowance will be applicable to the royalties on all oil as extracted, thereby allocating bonus to years when it is not received. Distortion would also result, because no depletion would be allowed against a bonus, which obviously represents a payment in advance for oil to be extracted.

The Regulation is, therefore, a proper and reasonable interpretation of the Revenue Act of 1921. Its application does not distort the taxpayer's income either in the year of the receipt of the bonus, or when the royalties are received. It carries out the basic intent of Congress to tax

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v. *Commissioner*, 20 B. T. A. 130, 131, reversed, 45 F. (2d) 573 (C. C. A. 5th); *Cf. Waggoner* v. *Commissioner*, 24 B. T. A. 657.

By the Courts:

Central Nat. Bank v. *United States*, 283 Fed. 368, 373 (C. C. A. 8th), dismissed, 264 U. S. 600; *Alland & Bro.* v. *United States*, 28 F. (2d) 792 (D. Mass.); *Hirschi* v. *United States*, 67 Ct. Cls. 637; *Burkett* v. *Commissioner, supra; Baton Coal Co.* v. *Commissioner, supra; Galatoire Bros.* v. *Lines*, 23 F. (2d) 676 (C. C. A. 5th). See *Constantine* v. *Wake*, 1 Sweeny (N. Y.) 239, 244; *Klein, Federal Income Taxation*, p. 439; *Crile* v. *Commissioner*, 55 F. (2d) 804 (C. C. A. 6th). *Cf. Jennings & Co.* v. *Commissioner*, 59 F. (2d) 33 (C. C. A. 9th).

true annual income. It is elastic, because the amount of depletion deduction varies as the proportion of the bonus to the sum of the bonus and royalties to be received varies. The amended Regulation is a valid interpretation of the Revenue Act of 1921.

II.

A sub-lessor is entitled to deductions for depletion on the bonus he receives in addition to royalties under Section 214 (a) (10) of the Revenue Act of 1921, and Article 215 (a) of Treasury Regulations 62, as amended.

Petitioner contends that a sub-lessor who receives a bonus in addition to royalties, is entitled to the depletion deductions allowed by Section 214 (a) (10) of the Revenue Act of 1921 on such bonus, although Article 215 (a), Regulation 62, as amended, only expressly mentions lessors.

The amended Regulation is based on the settled jurisprudence of this Court that where a lessor receives a bonus in addition to royalties, the bonus is an advance, or supplemental royalty—in effect, a part of the royalty in a lump sum or down payment. See *Work* v. *Mosier, supra; Burnet* v. *Harmel, supra.* Bonus and royalty are consideration for the lease and are income to the lessor.

A sub-lessor, who receives a bonus in addition to royalties, cannot be logically excluded from the benefit of the depletion provisions of the Revenue Act, and interpretative Regulation, merely because the Regulation expressly mentions only lessors. The Act itself does not evidence any intention to make such distinction, and the fact that a sub-

lessor receives bonus and royalties identical in character with those received by a lessor in leasing oil properties, brings him squarely within the intendment of the Act.

In *Lynch* v. *Alworth-Stephens,* 267 U. S. 364, the sub-lessor of mining property claimed deduction for depletion under the Revenue Act of 1916, on account of the royalties received under the sub-lease. This Court held that the sub-lessor would be so entitled, saying, in part:

> We agree with the Circuit Court of Appeals, 294 Fed. 194, that, "the plain, clear and reasonable meaning of the statute seems to be that the reasonable allowance for depletion in case of a mine is to be made to every one whose property right and interest therein has been depleted by the extraction and disposition of the product thereof which has been mined and sold during the year for which the return and computation are made. . . . And the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of a powerful intellect would discover."

No bonus was involved in that case, but if the sub-lessor be entitled to depletion deduction as to royalties under the Revenue Act and Regulations, then it necessarily follows that he is also entitled to such deductions with respect to the bonus he receives in addition to royalties, for it is but a part of royalty in a lump sum or down payment (*Work* v. *Mosier, supra; Burnet* v. *Harmel, supra*). That is particularly true in Louisiana, where a sub-lease is, in all respects, considered to be a new lease, the primitive lessee becoming lessor in the new or sub-lease, and where the relationship between the primitive lessee and the sub-

lessee is regulated by the rules of lease (*Smith* v. *Sun Oil Co.*, 165 La. 907).

The Commissioner has heretofore allowed deductions for depletion with respect to royalties received by the Smitherman and Baird partnerships (Exhibit "C," R. 182; Exhibit "F," R. 188; Opinion in C. C. A., R. 424, 428, 57 F. (2d) 32, 35).

That is consistent with the Government's admission in the *Waller* case (16 B. T. A. 424) and the concession in respondent's brief below in this case, to which reference has heretofore been made.

The right of a sub-lessor to depletion deductions under the Act and Regulations is apparent.

III.

The transfers here involved were sub-leases and not sales or assignments.

Although the transactions between Smitherman and the Ohio Oil Company, and Baird and the Gulf Refining Company, contain the elements essential to entitle the partnerships to depletion deductions, within the clear intendment of the Revenue Act and appropriate Treasury Regulations, since they both provide for the payment of royalties and bonuses, the Commissioner, while allowing depletion against the royalties received, has contended that the transactions were sales, and denied depletion against the bonuses.

Petitioner contends that the transactions were sub-leases because they provided for over-riding royalties payable in oil, for the reason that in Louisiana a sub-lease is

a new lease, characterized by new obligations flowing from the sub-lessee to the sub-lessor, such as the stipulation for a new rent; royalties, in Louisiana, being rent.

The Circuit Court of Appeals says that a sub-lease is characterized by the sub-lessor's retention of a "reversionary interest" in the lease; meaning a part of the term.

The two tests are incompatible. "Reversion," according to its common law connotation, is unknown in Louisiana and at civil law. Neither the reservation of a new rent for the entire term (35 C. J., p. 990), or the right of re-entry (16 R. C. L., p. 827), is sufficient to characterize the transfer of a lease as a sub-lease.

The decisions of the Circuit Court of Appeals upholding the Commissioner were rendered in *Waller* v. *Commissioner,* 16 B. T. A. 574, 40 F. (2d) 892, involving the Smitherman partnership; in *Herold* v. *Commissioner,* 17 B. T. A. 933, 42 F. (2d) 942, involving the Baird partnership; and in this case, involving both partnerships.

The opinion of the trial judge (R. 98) shows that his decision on this point was rendered only because he felt bound by the earlier decisions of the Circuit Court of Appeals, for the body of the opinion is entirely devoted to an exposition of his belief that petitioner was entitled to depletion and that the transactions effected sub-leases.

Subsequent to the decisions in the *Waller* and *Herold* cases, but prior to the decision of the Circuit Court of Appeals in this case, the Supreme Court of Louisiana decided *Roberson* v. *Pioneer Gas Co.,* 173 La. 313, which again affirms and restates the law of Louisiana respecting the transfer of oil and gas leases by sub-lease or by assignment precisely as contended by petitioner. On the touchstone of that decision the transfers ring true as sub-leases.

Seeking to break the force of that decision, the Circuit Court of Appeals said that it was "unable to agree that the question as to what constitutes a sub-lease as distinguished from an assignment was before the Supreme Court of Louisiana for decision."[9] With all deference, the doctrine of the *Roberson* case on the distinction between sub-lease and assignment is not dictum.

In the *Roberson* case it was absolutely necessary for the Supreme Court of Louisiana to determine the nature of the lease transfer involved, in order to determine its effect under *Smith* v. *Sun Oil Co.*, 165 La. 907, which held that the effect of a sub-lease was different from the effect of an assignment.[10]

We think the Circuit Court of Appeals has reached an incorrect conclusion in this case, because it has failed to recognize that there is a basic, fundamental difference between the common law conception of the nature of lease, and that of the civil law of Louisiana, inherited from the Civil Law of Rome, Spain, and France.

In *Viterbo* v. *Friedlander,* 120 U. S. 707, which is an epitome of the history of the Civil Code of Louisiana, this Court said:

> In considering this case, it is important to keep in mind that the view of the common law of England and of most of the United States, as to the nature of a lease for years, is not that which is taken by the Civil Law of Rome, Spain, and France, upon which the Civil Code of Louisiana is based.

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[9] In *Harrell* v. *United Carbon Co.*, 52 F. (2d) 790, the same court said that the *Roberson* case, with respect to effect of an assignment of part of a lease, established a rule of property which it was bound to follow under *Guffey* v. *Smith,* 237 U. S. 101.

[10] This is more elaborately argued at pages 36-37 of petitioner's brief in support of petition for certiorari.

> But as to the nature and effect of a lease for years, at a certain rent which the lessee agrees to pay, and containing no express covenant on the part of the lessor, the two systems differ materially. The common law regards such a lease as a grant of an estate for years, which the lessee takes a title in. . . . (Citing cases.)
>
> The Civil law, on the other hand, regards a lease for years as a mere transfer of the use and enjoyment of the property; . . . (Citing authorities.)

To the same effect is *Knapp* v. *Guerin*, 144 La. 761, where the Supreme Court of Louisiana, having before it an action for damages arising from the eviction of a tenant, said:

> We do not have to look to the common law for our guidance in the determination of the subject matter of this litigation, for it is governed by the provisions of the Civil Code derived from the Civil Law. For an able and elaborate discussion of the difference under the two systems see the case of Viterbo *v.* Friedlander, 120 U. S. 707.

The decision of the Circuit Court of Appeals in the *Waller* case, upon which its decision here is based, was postulated upon the following definition:

> An assignment of a lease occurs where a lessee parts with his entire interest in the demised premises or a part thereof for the unexpired term of the original lease, 16 R. C. L. 824, 826; 35 C. J. 988, 989. If the assignor convey less than his entire interest in the whole or a part of his lease, so that there still remains in him a reversionary interest, the transaction amounts to a sub-lease. 16 R. C. L. 826.

Clearly, that definition is inappropriate, since it is taken from common law sources, in support of which no Louisiana case is cited.

The Louisiana test by which sub-lease is to be distinguished from assignment, with particular reference to oil and gas leases, was restated in *Roberson* v. *Pioneer Gas Co., supra,* as follows:

> Our opinion, therefore, is that the transaction between the defendant and Pipes & Mack was merely an assignment of the lease on the 40 acres of land, and not a sub-lease. The reason for that is that the defendant thereby disposed absolutely of its interest in the lease on the 40 acres of land, and left no contractual relation whatever between the parties, or obligation on the part of the assignee in favor of the assignor. If the Pioneer Gas Company had retained an overriding royalty, or excess royalty, to be paid by Pipes & Mack to the Pioneer Gas Company, in addition to the one-eighth royalty to be paid by Pipes & Mack to the original lessors, the contract between the Pioneer Gas Company and Pipes & Mack would have been a sub-lease and not merely an assignment of the lease on the 40 acres of land. See Smith *v.* Sun Oil Company, 165 La. 907, 116 So. 379, and Johnson *v.* Moody, 168 La. 799, 123 So. 330. The distinction between an assignment of a lease and a sub-lease is that in an assignment, the assignor transfers his entire interest in the lease in so far as it affects the property on which the lease is assigned; whereas, in a sub-lease, the original lessee, or sub-lessor, retains an interest in the lease in so far as it affects the property sub-leased, by imposing some obligation upon the sub-lessee in favor of the sub-lessor, such as an obligation to pay additional rent to the sub-lessor. Robinson *v.* Freret, 9 La. Ann. 303; Audubon Hotel Co. *v.* Brauning, 120

> La. 1089, 46 So. 33, 124 Am. St. Rep. 456; Rev. Civ. Code, Art. 2725; Code Napoleon, Art. 1717; Baudry-Lacantinerie, Vol. 20, p. 616, Nos. 1052 and 1053; Beaudant, p. 374, Nos. 531 and 532; Marcade, Vol. 6, p. 112; Aubrey et Rau, Vol. 5, p. 336.

That test is logically founded on the Civil Law conception of the nature of sub-leases and assignments, according to which a sub-lease is a new lease, and governed by the laws relating to leases, while an assignment is a sale and governed by the laws relating to sales. In the case of a sub-lease two leases are superposed: the primitive lease, between the lessor and first lessee, and the sub-lease, between first lessee who becomes lessor, and the sub-lessee (*Smith* v. *Sun Oil Co.*, 165 La. 907).

To determine, therefore, whether there has been an assignment or a sub-lease of minerals, such as oil and gas, it is logically necessary to inquire how mineral rights in Louisiana may be sold or leased.

In Louisiana mineral rights may be dealt with in two ways: they may be sold, as any other property, or they may be leased for a fixed rental or on a royalty basis.

In *Spence* v. *Lucas*, 138 La. 763, wherein the Supreme Court of Louisiana was required to decide whether a mineral contract on a royalty basis was a sale or lease, it said:

> . . . Until the Legislature shall have passed laws specially applicable to the industry of mining, which is a new one in this state, the parties engaged in those pursuits *and the courts of the State will adhere to the jurisprudence on the subject and treat mineral contracts as* LEASES. (Italics and capitals ours.)

In *Logan* v. *State Gravel Co.*, 158 La. 105, after referring to the Louisiana jurisprudence that the grant of minerals

does not convey any specific corporeal thing, but only the right to extract them from the soil, in the nature of a servitude, the court said:

> But there are two ways in which that incorporeal right may be dealt with, viz: (1) It may be sold outright, as may "a servitude" or any other incorporeal thing (R. C. C. Art. 2449); or (2) the land may be leased for mining purposes for a fixed rental or on a royalty basis (R. C. C. Art. 2671),

and stated its conclusion to be:

> Our conclusion is that a mine or quarry on land adapted to mining or quarrying may be leased for a certain portion of the produce of such mine or quarry and the fact that said portion is called "royalty" instead of rent, is not of the least consequence. For "rent" (by whatever name called) is a certain profit in money, provisions, chattels or labor, issuing out of lands and tenements in retribution for the use.

That decision rests upon a basic difference between the consideration for a sale and the consideration for a lease. The consideration for a sale ought to consist of a sum of money; the consideration for a lease may consist in a portion of the fruits yielded by the thing leased. It is founded on the following Articles of the Civil Code:

> Article 2439. The contract of sale is an agreement by which one gives a thing for a price in current money, and the other gives the price in order to have the thing itself.
>
> Three circumstances concur to the perfection of the contract, to-wit: the thing sold, the price and the consent.

> Article 2464. The price of the sale must be certain, that is to say, fixed and determined by the parties.
>
> It ought to consist of a sum of money, otherwise it would be considered as an exchange.
>
> Article 2671 (under Title IX of Lease). The price should be certain and determinate, and should consist of money. However, it may consist in a certain quantity of commodities, or even in a portion of the fruits yielded by the thing leased.

And the court logically applied them to determine that the royalty under the mineral contract involved in *Logan* v. *State Gravel Co., supra,* was rent, for the payment of which the lessor was entitled to the lessor's privilege under Article 2705 of the Civil Code.

In *Board of Commissioners* v. *Pure Oil Co.,* 167 La. 801, a suit was brought for oil royalty due under an oil and gas lease. The court sustained a plea of prescription under Article 2538 of the Civil Code, which provides that the action for arrearages of rent prescribes in three years.

In each case the distinguishing test by which it was determined that the royalty was rent under a contract of lease was the nature of the royalty, that is, that it "consisted in a certain quantity of commodities or even in a portion of the fruits yielded by the thing leased." R. C. C. 2671.

The Circuit Court of Appeals thought there was a distinction between the transactions in those cases and the ones involved here, saying that there was no bonus paid in the *Logan* case, that the facts in *Board of Commissioners* case were practically the same, and that the royalty was held to be rent because the relationship of landlord and tenant existed (see *Waller* v. *Commissioner, supra*).

With all deference, that distinction does not exist. The opinion in *Board of Commissioners* v. *Pure Oil Co., supra,* affirmatively shows that a bonus was paid; it is the settled law of Louisiana that an oil and gas lease must be supported by a serious consideration in money, or an absolute obligation to drill in search of minerals,[11] and the transactions were held to be leases because the royalties stipulated were rent.

That is the foundation of the rule that the stipulation for an excess or overriding royalty in the transfer of an oil and gas lease characterizes it as a sub-lease. It is succinctly so stated in *Roberson* v. *Pioneer Gas Co., supra,* as follows:

> The reason why an obligation to pay an overriding royalty, or excess royalty, in a transfer of a lease, in whole or in part, and even though the transaction be called an assignment or a sale of the lease, characterizes the transaction as a sub-lease and not merely an assignment, is that, in oil and gas leases, under the settled jurisprudence of this state, the payment of a royalty is the payment of rent, and is not the payment of a price for the oil or gas rights, as if they were sold. See Spence *v.* Lucas, 138 La. 763, 70 So. 796; Logan *v.* State Gravel Co., 158 La. 106, 103 So. 526; Board of Commissioners of Caddo Levee District *v.* Pure Oil Co., 167 La. 801, 120 So. 373.

The excess or overriding royalties stipulated in the transactions here involved, measured by these tests, un-

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[11] It was so decided in *Murray* v. *Barnhart,* 117 La. 1023; *Anse La Butte Oil Co.* v. *Bobb,* 122 La. 415; *Girault* v. *Feucht,* 117 La. 275. See also *Cali* v. *National Linen Service Corp.,* 38 F. (2d) 35.

doubtedly were rent, and necessarily characterize the transactions as subleases.

The Smitherman transfer provided for the payment of $3,000,000.00 in cash, and $1,000,000.00 out of one-half of the first oil produced and saved from the premises, and required the Ohio Oil Company to pay over and deliver "the equal one-eighth (1/8) of all oil produced and saved from the above described premises as an excess royalty" (R. 33).

The Baird-Gulf transfer required the Gulf Refining Company, in addition to other payments and obligations under the contract, to deliver to him (Baird), or his transferees, the one-twenty-fourth royalty out of oil, as hereinabove provided, until the expiration of three years from this date, and a royalty of one-thirty-second of all oil that may be saved from that produced, after said date, and as long thereafter as oil may be produced from said property in paying quantities (R. 317).

The excess royalties are rent because they consisted "in a portion of the fruits yielded by the thing leased" (R. C. C. 2671, *supra*). They could not be sales because the price did not "consist of a sum of money" (R. C. C. 2464, *supra*).

The Circuit Court of Appeals considered *Smith* v. *Sun Oil Co.*, 165 La. 907, to hold that the retention of a "reversion," as that term is construed at common law, was necessary to characterize the transfer of a lease as a sublease. The Supreme Court of Louisiana, in *Roberson* v. *Pioneer Gas Co., supra,* completely demonstrates the fallacy of that conjecture. There the court said:

> In Smith v. Sun Oil Co. and in Johnson v. Moody, *supra,* we said that the obligation to pay an

> overriding royalty, in the contract, which, in each of those cases, the parties called an assignment, was imposed upon the so-called assignee "under penalty of reversion" to the original lessee, or sublessor; but we did not use the term "reversion" in the technical sense in which it is used at common law. The reversion which we had in mind was merely the reversion of the right of occupancy or use of the property; because a contract of lease under the civil law, unlike the common law in that respect, does not convey to the lessee, even temporarily, a title to the property leased, but conveys only the right to the use or enjoyment of the property. Rev. Civ. Code, Arts. 2669, 2674, Logan *v.* State Gravel Co., 158 La. 105, 103 So. 526.

The Circuit Court of Appeals, without the citation of authority, stated that the failure of the Ohio Oil Company to pay Smitherman the 1/8 over-riding or excess royalty would not deprive the company of its right to take the other seven-eighths. With all deference, that is not the law of Louisiana. The Civil Code provides:

> Article 2711. If the lessee makes another use of the thing than that for which it was intended, and if any loss is thereby sustained by the lessor, the latter may obtain the dissolution of the lease.
>
> The lessee, in that case, shall be bound to pay the rent, until the thing is again leased out; and the lessee is also liable for all the losses which the owner may have sustained through his misconduct.
>
> Article 2712. The lessee may be expelled from the property if he fails to pay the rent when it becomes due.[12]

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[12] This article was applied in *Louisiana Oil Refining Corp.* v. *Cozart*, 163 La. 90, and a lease was dissolved and the lessee expelled for failure to pay the rent under an oil and gas lease.

> Article 2729. The neglect of the lessor or lessee to fulfill his engagements, may also give cause for a dissolution of the lease, in the manner expressed concerning contracts in general, except that the judge cannot order any delay of the dissolution.

The Circuit Court of Appeals stated that royalty in Louisiana was not always rent, and inappropriately cited in support *Wilkins* v. *Nelson,* 155 La. 807. (See *Herold* v. *Commissioner, supra.*) In the cited case, by a transfer called a "sale," all the oil and gas was "sold" to the transferee for $900 cash and one-eighth of all the oil produced and saved from the premises. The transferer brought suit to set the transfer aside on account of lesion beyond moiety under Article 1861 of the Civil Code, which applies only to sales of immovables. This the Supreme Court refused to do. Later the same contract came before the court in a suit between the same parties, *Wilkins* v. *Nelson,* 161 La. 437, and the Supreme Court said:

> At the outset, it may be well to note that the mineral contract in question was declared to be a lease in Wilkins *v.* Nelson *et al.*, 155 La. 810; 99 So. 607, the plaintiff in that case having attempted, unsuccessfully, to annul said contract for lesion, alleging that it evidenced a sale of the oil and gas beneath the surface of the land.
>
> It is clear that the contract between the parties is not a sale, but an oil and gas lease, as decided by this court, and its complexion as such cannot be changed to a perpetual option from the mere incident that the habendum clause of a sale was inserted in the contract, conveying the oil and gas, as if it were an immovable, to the "purchaser, his heirs and assigns forever."

The observation of the Circuit Court of Appeals that Smitherman by the use of the terms "sell, assign, assignor, assignee, assignment" indicated an intention to sell, is without merit.

A complete answer is to be found in the cited jurisprudence. In *Smith* v. *Sun Oil Co., supra,* the transfer was held to be a sub-lease, although called an assignment; also, in *Wilkins* v. *Nelson, supra,* the contract was determined to be a lease, although the term "sell" was used. See also *Roberson* v. *Pioneer Gas Co., supra.* Moreover, the trial court found as a fact that it was the intention of the parties to the Smitherman-Ohio contract to make a sub-lease (R. 49).

The Civil Code and an unbroken jurisprudence in Louisiana establish these propositions: That mineral contracts on a royalty basis are leases; that royalty under an oil and gas lease is rent; that the retention of an overriding or excess royalty in the transfer of an oil and gas lease characterizes that transfer as a sub-lease, because the retained royalty is rent. By the test so established, the transactions here involved are sub-leases and the observation of the Circuit Court of Appeals, unsupported by the citation of statute or decision, that the bonus received was part of the purchase price, cannot make them sales.

There is no criterion in the Revenue Act or Regulations by which the transactions in this case could be gauged as sales. By the settled law of Louisiana, they are sub-leases, and we respectfully submit that they should so be held here (*Crooks* v. *Harrelson,* 282 U. S. 55; *Poe* v. *Seaborn,* 282 U. S. 101; *United States* v. *Cambridge Loan and Building Co.,* 278 U. S. 55; *Tyler* v. *U. S.,* 281 U. S. 497).

Conclusion.

The validity of Article 215 (a) of Treasury Regulations 62, as amended by T. D. 3938, as a proper application of Section 214 (a) (10) of the Revenue Act of 1921, is clearly established by the legislative history of the Revenue laws, the successive re-enactment of which without substantial change is presumptive evidence of Congressional approval of interpretative executive regulations.

The Regulation, as amended, is a proper and reasonable application of the Revenue Act, because it is clearly within the intendment of Congress to tax true annual income. Its provisions logically apply to sublessors who receive bonuses in addition to royalties.

The transactions in this case are clearly sub-leases, and within the purview of the Revenue Act and Regulations, particularly when tested by the settled law of Louisiana. They are Louisiana contracts affecting Louisiana property and by its law they cannot be sales or assignments.

The trial court found all the facts necessary to bring petitioner under the act and regulation, and to entitle him to the relief he seeks. The partnership discovered oil by their own efforts and not as the result of purchase of proven tracts; the cost in each case was disproportionate to the fair market value at the date of discovery; the fair market value on the basic date, and the value of the royalties expected to be received, were fixed with certainty.

We, therefore, respectfully submit that the judgment of the United States District Court for the Western District of Louisiana, and of the United States Circuit Court of Appeals for the Fifth Circuit herein, should be reversed and set aside, in so far as they deny petitioner the judg-

ment he prayed for; and that this cause should be remanded to the said Circuit Court of Appeals for the Fifth Circuit, with instructions to remand it to the United States District Court for the Western District of Louisiana, with instructions to have petitioner's income tax for the years 1921 and 1922 recomputed, allowing petitioner deduction for depletion on discovery revaluation on account of the bonuses or other sums received by the partnerships of which he was a member to the extent of his distributive share therein, and entered in accordance therewith.

All of which is respectfully submitted,

FRED R. ANGEVINE,
JOHN H. TUCKER, JR.,
HENRY P. DART, JR.,
HENRY P. DART,
Attorneys for E. G. Palmer,
Petitioner.

Appendix.

I.

Revenue Act of 1921, Section 214—

(a) That in computing net income there shall be allowed as deductions:

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

II.

Regulations 62, Article 215—

Depletion—Adjustments of accounts based on bonus or advanced royalty.—

(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

III.

V-47-2981

T. D. 3938

Article 216: Depletion—Adjustments of accounts based on bonus or advanced royalty.

INCOME TAX.

Depletion—Adjustment of accounts based on bonus or advanced royalty.

Treasury Department,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Article 215 of Regulations 45 (1920 edition), article 215 of Regulations 62, and article 216 of Regulations 65 are hereby amended to read as follows:

Art. 216 (215). *Depletion—Adjustments of accounts based on bonus or advanced royalty*—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in

such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

All rulings inconsistent herewith are hereby revoked.

D. H. Blair,
Commissioner of Internal Revenue.

Approved November 13, 1926.

A. W. Mellon,
Secretary of the Treasury.